INDEX

Subject Index

	Page
Petition for writ of certiorari	1
Summary statement of the matter involved	1
Statement with respect to jurisdiction	7
Questions presented	7
Reasons relied on for the allowance of the writ	8
Prayer for writ	11
Brief in support of petition	13
Opinions of the courts below	13
Jurisdiction	13
Statement of the case	14
Specification of errors	14
Statutes Involved	15
Summary of argument	17
Argument	18
Point A	17
Point B	17
Point C	18

Table of Cases Cited.

Esperson v. Commissioner, 49 F. (2) 259, cert. den. 284 U. S. 658	9, 20
Farmers & Ginners Cotton Oil Co. v. Commissioner, 41 B. T. A. 1083, 120 F. (2) 772 (Adv. Sheets)	11
Gregory v. Helvering, 293 U. S. 465	10, 22
Ben Grote, et al., 41 B. T. A. 247	19
Heiner v. Mellon, 304 U. S. 271	10, 24
Helvering v. Gowran, 302 U. S. 238	24
Helvering v. F. R. Lazarus & Co., 308 U. S. 252	9, 23, 25
Helvering v. Tex-Penn. Oil Co., 300 U. S. 481	10, 22, 24
Frank Kell, 31 B. T. A. 212 Acquiescence XIV-1, Cum. Bul. 11	20
Kornhauser v. United States, 276 U. S. 145	9, 22
Fremont C. Peck, et al., Executors, 31 B. T. A. 87	20
Renziehausen v. Lucas, 280 U. S. 387	10, 22, 24

INDEX—(Continued)

	Page
Rockford Malleable Iron Works, 2 B. T. A. 817	25
Roney v. Commissioner, 67 F. (2) 165	10, 22
United States v. Amalgamated Sugar Co., 72 F. (2) 755	11, 25
United States v. Utah-Idaho Sugar Co., 96 F. (2) 756	10, 25
Weiss v. Stearn, 265 U. S. 242	9, 19
Welch v. Helvering, 290 U. S. 111, 113-4	22

STATUTES CITED.

Internal Revenue Code, Sections 1141 and 1142	2
Revenue Act of 1934, c. 277, 48 Stat. 680:	
Section 22	15
Section 23	14
Section 117	5
Judicial Code, Section 240(a), as amended by the Act of Congress of February 13, 1925 (United States Code, Title 28, Section 347, 43 Stat. 938)	14

OTHER AUTHORITIES CITED

G. C. M. 1582, Cum. Bul. VI-1, 171	25

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No.....

FARMERS & GINNERS COTTON OIL COMPANY,
Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

MAY IT PLEASE THE COURT:

The petition of the Farmers & Ginners Cotton Oil Company respectfully shows unto this Honorable Court:

Summary Statement of the Matter Involved

This petition is filed to review the judgment of the Circuit Court of Appeals for the Fifth Circuit reversing the decision of the United States Board of Tax Appeals in favor of the petitioner and against the respondent.

From the determination of a deficiency for the taxable year ended June 30, 1936, by the respondent, the petitioner took an appeal to the United States Board of Tax Appeals (R. 5,11). The Board of Tax Appeals entered its decision in favor of the petitioner that there was no deficiency in income tax for such fiscal year (R. 48). The respondent filed a petition in the Circuit Court of Appeals for the Fifth Circuit to review this decision (R. 49, et seq.) pursuant to provisions of Sections 1141 and 1142 of the Internal Revenue Code. The Circuit Court of Appeals reversed the decision (R. 119) and denied a petition for rehearing filed by this petitioner (R. 124).

The matter involved on which primary reliance is placed here, is whether a taxpayer engaged in the business of crushing cottonseed to make initially what is known as crude cottonseed oil (hereinafter called "crude oil") and selling the same, is entitled, under the Revenue Act of 1934, to reduce its income by the entire amount of losses realized on closing out contracts for the purchase of refined cottonseed oil (hereinafter called "refined oil") in the future entered into concurrently with or shortly after, sales of crude oil to offset and compensate for such sales, or whether they constitute losses on the disposition of capital assets the deduction of which is limited under Section 117 of that Act. An alternative question is whether such losses should serve to reduce the realization on the sales of crude oil rather than be deducted as independent losses.

The petitioner is a corporation. It buys cottonseed, crushes it, and sells the products derived therefrom.

One of such products is crude oil, which deteriorates rapidly, especially in warm weather. Crude oil, however, is not the ultimate product, but that is refined oil. Crude oil must be refined to be generally salable to the public. (R. 35, 83). The petitioner's storage facilities for crude oil are not more than one-sixth of its annual production, and larger storage facilities would be uneconomical. Because of these circumstances, petitioner cannot always retain its crude oil until it can obtain what it regards as a favorable price, but sells during the operating season at the market price whenever its storage tanks are full. When forced to sell its crude oil at prices which it deems unsatisfactory, it is petitioner's practice to buy, on margins, refined oil for future delivery, which later it sells before the delivery date. The petitioner entered into these contracts for the purchase of refined oil futures only to offset sales of like quantities of crude oil at prices which it regarded as unsatisfactory. (R. 36). Purchase of cottonseed was not a practical method of protecting petitioner against sales at unfavorable prices (R. 38) as only small profits or even losses might be involved as a result of the narrow spread between prices of cottonseed and crude oil (R. 65-6, 79-81). Yet to avoid cessation of operations, to maintain contacts for the supply of cottonseed and to avoid losses on loans, purchases of cottonseed must be continued however unsatisfactory the margin between the two prices (R. 65, 73) and early in the season cottonseed must be crushed, as received, because it also is perishable (R. 64, 74).

The petitioner might have its crude oil refined and

stored for its account, and had done so in one year. The two processes accomplish essentially the same economic result. The process actually followed, however, was a more efficient and less expensive method than this alternative. (R. 37-8, 72, 87-8.) This practice of buying futures in similar circumstances is generally, if not universally, followed by others engaged in the same line of business as petitioner. (R. 36, 90, 97, 103).

The process of refining crude oil involves the elimination of impurities found in the crude oil and the loss of from 6% to 9% of its weight (R. 92, 75). The rules of the exchange on which the futures were purchased provide that purchases are made with the understanding that actual receipt and/or delivery is intended and at times delivery is actually required on futures contracts. This is one of the factors that keeps the price of refined oil futures in line with that of crude oil. The petitioner however, did not take delivery on any of its contracts. (R. 37, 94, 88). In October, November and December, 1935, the price of cottonseed advanced relatively more than did the price of crude oil, thus reducing the spread between these two prices to an unsatisfactory point, where perhaps losses might have been involved. (R. 69, 75). Nevertheless, in order to keep running, it was necessary to buy cottonseed and sell crude oil (R. 70). To meet this situation, the petitioner sold crude oil and purchased refined oil futures on margin to offset the sales of crude oil. The sales of crude oil aggregated 2,940,000 pounds and the purchases of refined oil futures 2,760,000 pounds. On the closing out of the contracts for refined oil futures the petitioner sustained a

total loss of $24,024.30 which the respondent disallowed to the extent of the excess thereof over $2,000 on the ground that the losses were realized on the sale of capital assets and limited to that amount by Section 117 of the Revenue Act of 1934. (R. 36-8).

The petitioner maintained before the Board of Tax Appeals and the Circuit Court of Appeals that the procedure adopted by it in the taxable year here involved was essentially a method chosen for the sale of its crude oil to what it deemed to be the greatest advantage; that because of the essential similarity between crude oil and refined oil and the direct relationship between their respective prices, no taxable disposition of the crude oil should be deemed to have been made in cases where there were offsetting purchases of refined oil futures; that, if the sales were nevertheless recognized for tax purposes, the dealings in refined oil futures constituted a method of disposing of crude oil at hoped for more advantageous prices, and of insuring against forced disposition of crude oil at losses or unsatisfactory margins, adopted for the purpose of continuing operations without loss, and that, accordingly, losses sustained in such dealings in refined oil futures constituted ordinary and necessary expenses of doing business; and that the refined oil contracted to be purchased in the offsetting transactions, or the contracts therefor, was substituted as the stock-in-trade of petitioner in lieu of the crude oil or that the contracts or refined oil became property of a kind which would properly be included in the inventory of the petitioner if on hand at the close of the taxable year or property held by the petitioner primarily for sale

to customers in the ordinary course of its trade or business.

The Board of Tax Appeals, conceiving that the petitioner did not buy the futures merely as a speculation, but solely to replace its manufactured product which it was forced to sell at a price which it deemed unsatisfactory, that all of the transactions were directly related to the petitioner's business of production and sale and that in this aspect the question is substantially the same as that involved in hedging operations, which this respondent and the Board had ruled did not fall within the scope of Section 117, entered its decision for the petitioner. (R. 38, 41 B. T. A. 1083) (an earlier decision against the petitioner reported in 41 B. T. A. 255 was withdrawn). By findings that the futures contracts were neither stock-in-trade nor property held by the petitioner primarily for sale to customers in the ordinary course of its trade or business, the Board of Tax Appeals appears to have disposed of certain of petitioner's contentions. (R. 38). Since these finding, however, are findings of ultimate fact or mixed findings of fact and law, the petitioner deems that it is not bound thereby and urges that the decision of the Board of Tax Appeals in favor of petitioner can be supported on grounds which appear to be in conflict with these findings. The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals, confining its opinion largely, if not exclusively, to the holding that the transactions of the petitioner in refined oil futures did not constitute hedges in the accepted sense, and on the basis of that holding decided against the petitioner. Hutcheson, Circuit

Judge, dissented (R. 114-8) (120 F. (2d) 772 Adv. Sheets.)

The petitioner filed, in the Circuit Court of Appeals, a petition for rehearing (R. 120) which was denied (R. 124).

Statement With Respect to Jurisdiction

(1) Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code, as amended by the Act of Congress of February 13, 1925 (United States Code, Title 28, Section 347, 43 Stats. 938). The case involves the construction of a Federal tax statute, to-wit, the Revenue Act of 1934, 48 Stats. 680.

(2) The date of the judgment to be reviewed is June 9, 1941 (R. 119). The petition for rehearing was denied July 11, 1941 (R. 124).

Questions Presented

The questions presented are:

(1) Whether final effect shall be given, for tax purposes, to a disposition of a fungible commodity when offset and compensated for by the acquisition of the right to acquire the same commodity, further processed, at a directly related price.

(2) Whether, if such disposition is recognized for tax purposes, losses sustained in respect of offsetting contracts for the acquisition of the same commodity, further processed, at directly related prices, which were entered into for the purpose of facilitating and are directly related to, the sale, at more advantageous prices, of the commodity disposed of and of enabling the manufac-

turer to continue the manufacture of such commodity out of other material, are deductable as ordinary and necessary expenses of doing business.

(3) Whether the contract right to acquire a fungible commodity, or the fungible commodity so contracted to be acquired, in substitution for and to offset sales of, the same commodity in a less highly processed state at a directly related price, is a capital asset or constitutes part of the stock-in-trade of a taxpayer or property of a kind which would properly be included in the inventory of a taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Reasons Relied on for the Allowance of the Writ

A review of this cause on certiorari to the said Circuit Court of Appeals for the Fifth Circuit is of general and peculiar importance for the following reasons:

(1) The specific question of Federal law, whether a loss sustained upon the closing out of a futures contract for the acquisition of a fungible commodity entered into for the purpose of offsetting the sale of the same commodity less highly processed but at a directly related price is deductible as an ordinary and necessary expense, or without limitation as not involving a loss upon the disposition of a capital asset, has not been settled by this Court and it is believed that it should be settled because the practice involved is one generally, if not universally, followed, in appropriate situations, by owners of cottonseed oil mills who do not also own refining faci-

lities. Doubt is cast upon the correctness of the judgment of the Court below by the dissent therefrom.

(2) The extent to which final effect shall, for tax purposes, be given to sales of a fungible commodity which are offset and compensated for by the acquisition of contrast rights to acquire the same commodity further processed and at directly related prices, has not been decided by this Court. The petitioner is aware of the technical differences between the commodity in its different stages of processing which might require that final effect be given to such dispositions. Nevertheless, the decision of the Court below in this partcular is possibly in conflict with principles underlying the decision of this Court in *Weiss v. Stern*, 265 U. S. 242, and the decision of the court below in *Esperson v. Commissioner*, 49 F. (2d) 259, cert. den. 284 U. S. 658. As the other questions do not arise if this question is decided favorably to petitioner, the ground is urged to avoid a waiver of petitioner's rights.

(3) The decision of the court below that expenses incurred, and losses sustained, in the closing out of futures contracts for the purchase of a fungible commodity entered into for the purpose of effectuating sales, at more advantageous prices, of the same commodity in a less highly refined state manufactured by a taxpayer do not constitute deductible ordinary and necessary expenses of doing business appears to be in conflict with the principles underlying the decisions of this court in *Kornhauser v. United States*, 276 U. S. 145, and *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252.

(4) In its failure to hold that contracts to acquire a

fungible commodity, or the fungible commodity contracted to be acquired pursuant to such contracts, which are entered into solely to offset and compensate for sales of the same commodity manufactured by a taxpayer at directly related prices, but in a less highly processed state, do not constitute a part of the stock-in-trade of the taxpayer, or property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, the decision of the court below appears to be in conflict with the decisions of this Court in *Renziehausen v. Lucas*, 280 U. S. 387, and *Heiner v. Mellon*, 304 U. S. 271, and with the decision of the Circuit Court of Appeals for the Fourth Circuit in *Roney v. Commissioner*, 67 F. (2d) 165. The result so attained is, in its economic aspects, so nearly identical with the result that would have been attained had the petitioner adopted the alternative process, for which it was a substitute, of having its crude oil refined and held for its account that different tax consequences should not follow. As under the above decisions the refined oil would undoubtedly, have constituted a part of the stock-in-trade of the petitioner, it would be emphasizing form as against substance for different results to follow from the two processes . Cf. *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481; *Gregory v. Helvering*, 293 U. S. 465.

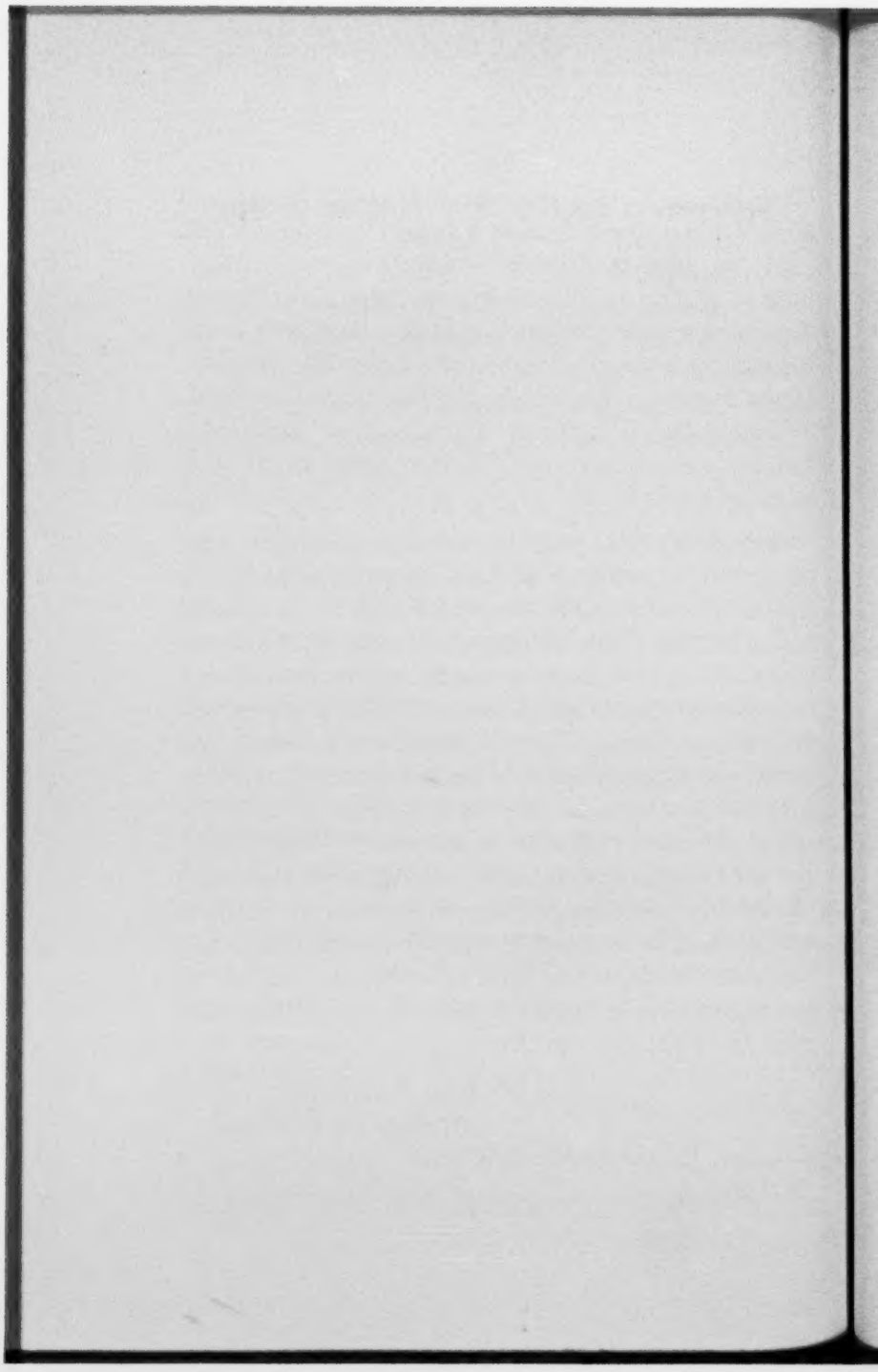
(5) The decision of the Court below appears also to be in conflict with *Heiner v. Mellon*, supra, and *Roney v. Commissioner*, supra, and with the principles underlying the decisions of the Circuit Court of Appeals for the Tenth Circuit in *United States v. Utah-Idaho Sugar*

Company, 96 F. (2d) 756, cert. den. 305 U. S. 631, and *United States v. Amalgamated Sugar Company*, 72 Fed. (2d) 755, in that intangible contract rights or obligations to acquire or sell property are there given effect in determining what property is part of a taxpayer's stock-in-trade, or is required to be included in his inventory. In the first two cases, whisky certificates were involved; in the last two, firm contracts to sell sugar. Similar effect has not been given by the court below to contracts to acquire refined oil.

WHEREFORE, your Petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Fifth Circuit, commanding that court to certify and to send to this Court for its review and determination, on a day certain to be named therein, a full and complete transcript of the record and all proceedings in the case numbered and entitled on its docket Number 9802, *Commissioner of Internal Revenue, Petitioner, v. Farmers & Ginners Cotton Oil Company, Respondent*, and that the said judgment of the said Circuit Court of Appeals for the Fifth Circuit may be reversed by this Honorable Court, and that your Petitioner may have such other and further relief in premises as to this Honorable Court may seem meet and just; and your Petitioner will ever pray.

WILLIAM B. WHITE,
Attorney for Petitioner.

BRADLEY, BALDWIN, ALL & WHITE,
Of Counsel.



IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No.....

FARMERS & GINNERS COTTON OIL COMPANY,
Petitioner,

vs.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

I

The Opinions Below

The opinion of the Board of Tax Appeals is reported in 41 B. T. A. 1083 and is found at page 35 of the Record. The opinion of the Circuit Court of Appeals is reported in 120 F. (2d) 772 (Adv. Sheets) and is found at page 114 of the Record.

II

Jurisdiction

(1) Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code as amended by the

Act of Congress of February 13, 1925 (U. S. Code, Tit. 28, Sec. 347, 43 Stat. 938.)

(2) The date of the judgment to be reviewed is June 9, 1941 (R. 119). The petition for rehearing was denied July 11, 1941 (R. 124).

III

Statement of the Case

A statement of the case involved has been given under heading "Summary Statement of the Matter Involved" in the petition for a writ of certiorari, and, in the interest of brevity, is not here repeated.

IV

Specification of Errors

(1) The Circuit Court of Appeals erred in holding that losses on petitioner's transactions in refined oil should be treated as independent losses instead of as reducing petitioner's realizations on crude oil which the futures contracts for refined oil were purchased to replace.

(2) The Circuit Court of Appeals erred in not holding that losses and expenses incurred in petitioner's transactions in contracts for refined oil futures were not deductible as ordinary and necessary expenses of doing business pursuant to Section 23(a) of the Revenue Act of 1934.

(3) The Circuit Court of Appeals erred in holding that petitioner's losses in its dealings in contracts for refined oil futures were losses upon the sale or exchange

of capital assets, the deduction in respect of which was limited by Section 117 of the Revenue Act of 1934, instead of ordinary losses deductible to the full extent thereof pursuant to Section 23(f) of said Act.

(4) The Circuit Court of Appeals erred in reversing the decision of the Board of Tax Appeals.

V

Statutes Involved

Inasmuch as the taxable year is one ending on June 30, 1936, the statute primarily involved is the Revenue Act of 1934, C. 277, 48 Stat. 680. The pertinent parts thereof are shown below.

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any tax payer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. (U. S. C., Title 26, Sec. 22.)

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise. (U .S. C., Title 26, Sec. 23.)

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) *Definition of Capital Assets.*— For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the in-

ventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * * (U. S. C., Title 26, Sec. 101.)

VI

Summary of the Argument

A

The petitioner's transactions in contracts for the delivery of refined oil were essentially a part of its process of marketing crude oil and, until such transactions were completed, it was not possible to determine whether a profit had been made, in fact, upon the manufacture and sale of the crude oil which these contracts were purchased to replace.

B

The expenses involved in the purchase and closing-out of contracts for the future delivery of refined oil, including losses sustained thereon, were ordinary and necessary expenses of engaging in the petitioner's business and were deductible to the full extent thereof.

C

The losses sustained by the petitioner in the purchase and closing-out of contracts for the future delivery of refined oil were not losses on the sale of capital assets and were deductible to the full extent thereof.

VII
ARGUMENT
A

The petitioner's transactions in contracts for the delivery of refined oil were essentially a part of its process of marketing crude oil and, until such transactions were completed, it was not possible to determine whether a profit had been made, in fact, upon the manufacture and sale of the crude oil which these contracts were purchased to replace.

The petitioner's case is based primarily upon the contention, which, it submits is abundantly sustained by the evidence, that its dealings in refined oil futures, in the year here involved, constituted an integral part of its business of manufacturing and selling cottonseed oil. The Board of Tax Appeals adopted that view in its opinion. It is submitted that the judgment of the court below can be sustained only if such dealings be treated as independent business ventures wholly unrelated to the crude oil marketing problem.

The Circuit Court of Appeals did not, in its opinion, deal, in terms, with all of the contentions made by the petitioner, but rested its conclusion primarily upon its holding that the transactions of petitioner in refined oil futures did not constitute hedges in the generally

accepted sense of that term and, accordingly, did not come within the decision of the Board of Tax Appeals in *Grote v. Commissioner*, 41 B. T. A. 247. That court did not deny that transactions in crude oil might not be hedged by compensating transactions in refined oil, but, on the contrary, adopted in its statement of the facts, a finding by the Board of Tax Appeals that there is a direct relationship between the market prices of refined oil and crude oil as of any given date. That transactions in refined oil futures are appropriate vehicles for hedging transactions in crude oil inevitably results from price relationship and from the great similarity between crude oil and refined oil, the latter merely being crude oil with impurities removed, and the process of manufacturing refined oil necessary involving the earlier production of crude oil. It is of the greatest significance here that, as an economic consequence of the direct relationship between the prices of the commodity in its two different stages of processing, transactions in the commodity at one stage may be offset by compensating transactions in it at the other stage, with no more than immaterial variation. Of importance also is the fact that cottonseed oil, both crude and refined, is obviously a fungible commodity.

There is a question whether income tax results should follow from a transaction in a fungible commodity in the event that there is a precisely compensating transaction in the same commodity. Recognition of gain or loss essentially requires an exchange of property for other property differing materially either in kind or extent. *Weiss v. Stern*, 265 U. S. 242, involves an appli-

cation of this doctrine. The decision of the court below in *Esperson v. Commissioner*, 49 F. (2d) 259, cert. den. 284 U. S. 658, may involve an application of this principle, and it seems to be the basis of the decisions of the Board of Tax Appeals in *Frank Kell*, 31 B. T. A. 212, issue 4, (in which the respondent has acquiesced, XIV-1 Cum. Bul. 11) and in *Fremont C. Peck et al, Executors*, 31 B. T. A. 87, (issue 2.) The petitioner however, recognizes that, notwithstanding the economic relationship which exists between the prices of cottonseed oil in its crude and refined states and permits the consumation of offsetting transactions, there are technical differences on the basis of which the facts here can be distinguished from the facts in the cases cited, and that these differences may make it probable that the decision, sub silentio, of the court below on this point is not so plainly in conflict with the decisions cited as to lead this Court to grant a petition for a writ of certiorari on this ground. Nevertheless, petitioner does not desire to waive its claims in respect of this legal proposition because it is only as a result of an adverse decision on this question that the other questions urged in the petition properly arise.

B

The expenses involved in the purchase and closing-out of contracts for the future delivery of refined oil, including losses sustained thereon, were ordinary and necessary expenses of engaging in the petitioner's business and were deductible to the full extent thereof.

As we have said, the court below did not deal, in terms, with this contention made by the petitioner ex-

cept as its discussion of hedges is such a dealing. The petitioner did not urge there that its transactions in refined oil futures constituted hedges in the generally accepted sense of that term and it does not make that argument here, although they appear to be called hedges in the trade. (R. 85, 102.) But it does not at all follow that the petitioner should not prevail, for losses incurred in hedges are not specifically allowed as deductions by the Revenue Act of 1934. The theory upon which they are allowed is that hedging is essential to conservative operations in certain businesses and constitutes a form of insurance; expenses and losses incurred therein are, accordingly, deductible as ordinary and necessary expenses of doing business. We urge here that petitioner's transactions in refined oil futures were an appropriate method of marketing, ultimately, the crude oil which business necessity forced it to dispose of at unsatisfactory prices, which might indeed involve losses, that expenses incurred in the marketing of products made by a manufacturer are ordinary and necessary expenses of its business and that the course pursued by the petitioner was the economic equivalent (with immaterial variations) of having its crude oil refined, stored for its account and subsequently sold. In the latter procedure, the petitioner would have paid a fee for refining its crude oil, charges for storage equivalent to rent and other expenses incidental to the sale of the refined oil thus held for its account. These expenses would be undoubtedly deductible as ordinary and necessary expenses of doing business—rental is specifically mentioned in Section 23(a) of the statute—and the sales price of the

refined oil would be the sales price of the petitioner's stock of goods. Cf. *Renziehausen v. Lucas*, 280 U. S. 387; *Roney v. Commissioner*, 67 F. (2) 165. Furthermore, this process was adopted to enable petitioner to crush more cottonseed and might properly be charged to the expense of that operation.

The decision of this case should not turn upon the narrow point that the petitioner adopted the course of selling the crude oil and offsetting such sales by the purchase of refined oil futures instead of having the crude oil refined for its account, particularly when the former process is the better adapted to produce the greater net income. That would involve too great an emphasis upon form as against substance. Such an emphasis is not consistent with *Gregory v. Helvering* 293 U. S. 465, *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, or *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252.

Nor is it of consequence that the petitioner did not engage in this marketing process every year or at all times during this year. Cf. *Kornhauser v. United States*, 276 U. S., 145, and the comment thereon in *Welch v. Helvering*, 290 U. S. 111, 113-4.

The court below calls attention to the fact that the petitioner, in these transactions, merely exchanged its market risk from crude to refined. This the petitioner freely admits. But as the object of this transfer was to permit other crude oil to be manufactured and to market crude oil already manufactured to the greatest net advantage taking account of the necessity of the petitioner's continuance in business, its limited storage facilities and the possible deterioration of the crude oil, neither

the object nor the effect of the transfer of the risk was to engage in an essentially different business; but rather they were to continue the very business in which the petitioner was primarily engaged. It should necessarily follow that the expenses and losses then incurred should be treated as ordinary and necessary expenses of the business, for the "Federal income tax is aimed at net income determined from gross income less items such as necessary expenses incurred or capital consumed in earning it." *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. at page 254.

C

The losses sustained by the petitioner in the purchase and closing-out of contracts for the future delivery of refined oil were not losses on the sale of capital assets and were deductible to the full extent thereof.

The definition of the term "capital assets" in Section 117 excludes stock-in-trade of the taxpayer, other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Losses realized upon the sale of assets so excluded are deductible in full under Section 23(f) of the Revenue Act of 1934. In its findings of fact the Board of Tax Appeals stated that the contracts for refined oil futures were neither stock-in-trade nor property held by the petitioner primarily for sale to customers in the ordinary course of its trade or business. (R. 38) These findings are adverted to by the court below in its opinion

but are not commented on otherwise nor made specifically the basis of the court's holding, except perhaps inferentially in the further statement that the petitioner was not a manufacturer of refined oil. Because the petitioner prevailed before the Board of Tax Appeals, there was no occasion for it to undertake to controvert these findings before the Circuit Court of Appeals, nor is there any occasion so to do in this court, except for the purpose of defending the decision of the Board of Tax Appeals on other grounds than that on which it was rested in the event its grounds are found to be untenable. Cf. *Helvering v. Gowran* 302 U. S. 238. The petitioner asserts that these findings are within the class of ultimate findings which are not binding on the appellate courts. *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, 491. The subsidiary facts as to the relationship between crude and refined oil and the prices thereof, and the purpose and effect of the acquisition of refined oil futures contracts are not in dispute. It is submitted that the above mentioned conclusions drawn therefrom by the Board of Tax Appeals are erroneous, at least as to the status of the refined oil or the futures contracts therefor as stock-in-trade of the petitioner. The Board of Tax Appeals, however, did not undertake to pass upon the question whether the contracts for refined oil futures should be inventoried.

Decisions of this Court establish conclusively that the crude oil manufactured by the petitioner was part of its stock in trade. *Heiner v. Mellon* 304 U. S. 271, *Renziehausen v. Lucas*, supra. These cases are also authority for the proposition that if the petitioner had

had its crude oil refined and held for its account, the resulting refined oil would have been part of the stock-in-trade of the petitioner. The *Mellon* and *Roney* cases are authority for the proposition that an intangible warehouse receipt or certificate, or the commodity represented thereby, may constitute part of the stock-in-trade of the owner thereof or at least property of a character which should be included in the inventory if on hand at the close of the taxable year. *Rockford Malleable Iron Works*, 2 B. T. A. 817, in which the respondent has acquiesced, and G. C. M. 1582, Cum. Bul. VI-1, page 171, are to the same effect. The converse of this situation is presented in *United States v. Utah-Idaho Sugar Co.*, 96 F. (2d) 756 (cert. den. 305 U. S. 631) and *United States v. Amalgamated Sugar Co.*, 72 F. (2d) 755.

Essentially what the petitioner did in this case was to substitute for the fungible commodity, crude oil, which constituted part of its stock-in-trade and which should have been included in the inventory of the petitioner if on hand at the close of the taxable year, firm contracts for the purchase of refined oil, another fungible commodity derived in a process of further manufacture of the original crude oil, and so directly related in price as to be readily exchangeable therefor with appropriate price adjustments. To hold this process involved the final disposition of the original stock-in-trade and entry into a separate business of dealing in refined oil futures, or refined oil, in such manner as to constitute them or it, capital assets is to ignore the realities of the situation. Cf. *Helvering v. F. & R. Lazarus & Co.*,

supra, 308 U. S. 255. Such a contention, however, is the only one justifying the judgment of the court below, but is refuted by the fact that it is a practice generally, if not universally, engaged in by processors of cotton-seed oil who do not own their refining facilities. An adverse decision of this question will impose a serious hardship upon such manufacturers. The limitations on the amount of deductible losses from the sale or other disposition of capital assets have been carried forward into succeeding statutes. Applying the limitation to these manufacturers will result in their having to pay taxes upon gains in transactions of this character while they are denied deductions for losses although the transactions are in fact an integral part of their business. There appears to be no reason to suppose that Congress intended such an unjust result or one so burdensome upon those engaged in this business.

Respectfully submitted,

WILLIAM B. WHITE,
Birmingham, Alabama,
Attorney for Petitioner.

BRADLEY, BALDWIN, ALL & WHITE,
Of Counsel.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and other authorities involved	2
Statement	2
Argument	6
Conclusion	10
Appendix	11

CITATIONS

Cases:	
Board of Trade v. *Christie Grain and Stock Co.*, 198 U. S. 236	8
Covington v. *Commissioner*, 42 B. T. A. 601, affirmed, 120 F. (2d) 768, pending on petition for certiorari, Nos. 693–694, present Term	7
United States v. *Coffee Exchange*, 263 U. S. 611	8
Statutes:	
Revenue Act of 1934, 48 Stat. 680:	
Sec. 22 (U. S. C., Title 26, Sec. 22)	11
Sec. 23 (U. S. C., Title 26, Sec. 23)	11
Sec. 117 (U. S. C., Title 26, Sec. 101)	6, 12
Miscellaneous:	
A. R. M. 100, 3 Cum. Bull. 66, 68 (1920)	7
Baer and Woodruff, Commodity Exchanges (1929), pp. 87–88	8
Circular No. 151, United States Department of Agriculture, Hedging in Grain Futures, pp. 30–32 (June, 1931)	9
G. C. M. 17322, XV–2 Cum. Bull. 151 (1936)	7, 14
Hoffman, Future Trading upon Organized Commodity Markets (1932), pp. 4, 382	8
Senate Hearing before the Committee on Agriculture and Forestry on S. 1414, 70th Cong., 1st Sess., p. 9	9
Treasury Regulations 86:	
Art. 22 (c)–1	7, 12
Art. 23 (f)–1	13
Art. 117–1	13
Art. 117–2	13

423663—41——1

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 671

FARMERS & GINNERS COTTON OIL COMPANY,
PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 35–39) is reported in 41 B. T. A. 1083. Four members dissented and there were two separate dissenting opinions (R. 39–47). The opinion of the Circuit Court of Appeals (R. 114–118) is reported in 120 F. (2d) 772.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 9, 1941 (R. 118). A petition for rehearing filed on June 28, 1941 (R. 119), was

denied on July 11, 1941 (R. 123). The petition for writ of certiorari was filed on October 1, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether losses sustained by the taxpayer, a manufacturer of crude cottonseed oil, from the sales of certain contracts for the future delivery of refined cottonseed oil were deductible only to the extent provided in Section 117 (d) of the Revenue Act of 1934 because they were losses from the sale of "capital assets," as defined in Section 117 (b).

STATUTES AND OTHER AUTHORITIES INVOLVED

The pertinent statutes and other authorities involved are set forth in the Appendix, *infra*, pp. 11–16.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 35–38) from the evidence (R. 62–109) are as follows:

The taxpayer corporation is engaged in the business of operating a cottonseed-oil mill. It buys cottonseed, crushes the seed, and sells the products derived therefrom, consisting of crude cottonseed oil, meal, linters, hulls, fibers, and bran. The crude cottonseed oil is perishable and deteriorates rapidly, especially in warm weather. The crude oil storage facilities of the taxpayer held not more than one-sixth of the annual production of the mill.

Larger storage facilities were impractical not only because of the expense but also because the oil would deteriorate if held. The taxpayer, because of these circumstances, could not retain its crude oil until it could obtain what it regarded as a favorable price, but had to sell during the operating season at the market price whenever its storage tanks were full (R. 35–36).

The practice of the taxpayer has been to buy futures in refined oil when, but only when, it was forced to sell crude at prices which it regarded as unsatisfactory. Refined cottonseed oil may be kept for long periods and has a market throughout the year on produce exchanges. There is a direct relationship between the market price of refined oil and the market price of crude oil as of any given date. The taxpayer purchased quantities of refined oil for future delivery only to offset the sale of like quantities of crude at prices which it regarded as unsatisfactory. It would first sell the crude at prevailing market price and then place orders with brokers for the purchase of refined futures at prices named by the taxpayer. Sometimes several weeks would intervene before the purchase could be made at the prices named. The practice of buying futures was generally followed by others engaged in the same business as the taxpayer (R. 36).

The taxpayer sold 2,280,000 pounds of crude during the taxable year at prices satisfactory to it and

made no offsetting purchases of futures in regard to those sales. It sold the following quantities of crude on the dates mentioned at prices unsatisfactory to it (R. 36):

Date	Pounds	Date	Pounds	Date	Pounds
10/16/35	180,000	10/22/35	180,000	11/20/35	300,000
10/16/35	420,000	10/25/35	60,000	12/6/35	180,000
10/18/35	60,000	10/28/35	180,000	12/6/35	120,000
10/22/35	300,000	10/30/35	360,000	1/8/36	600,000

It purchased futures of refined oil to offset those sales, and its dealings in those futures are shown in the following table (R. 37):

Date acquired	Date sold	Quantity	Losses
		Pounds	
11-22-35	4-13-36	180,000	$2,462.13
11-22-35	4-13-36	120,000	1,653.42
11-26-35	4-13-36	180,000	2,336.13
11-26-35	4-13-36	120,000	1,545.42
1-9-36	4-13-36	300,000	1,328.55
1-9-36	4-13-36	180,000	887.13
1-9-36	4-13-36	120,000	615.42
1-9-36	4-13-36	120,000	639.42
1-9-36	4-13-36	180,000	959.13
2-7-36	4-13-36	60,000	331.71
2-7-36	4-13-36	300,000	1,658.55
12-12-35	4-13-36	120,000	1,521.42
12-12-35	4-13-36	60,000	736.71
12-17-35	4-18-36	120,000	1,389.42
12-17-35	4-21-36	60,000	766.68
12-19-35	4-21-36	60,000	766.68
12-20-35	4-21-36	120,000	1,545.36
12-28-35	4-21-36	60,000	772.68
1-9-36	6-25-36	300,000	2,108.34
Total		2,760,000	24,024.30

The taxpayer bought the futures on margin. The quantity unit in transactions in crude and refined oil is a tank of 60,000 pounds. The rules of the exchange on which the futures were purchased

provide that purchases (R. 37) "of commodities for future delivery are made with the distinct understanding that actual receipt and/or delivery is intended," but the taxpayer never took delivery of any of the refined. Instead, it sold its contracts for future delivery.

The practice of buying futures was a more efficient and less expensive way for the taxpayer to await more favorable markets than the alternative of having its crude oil manufactured into refined and held in storage as its own property. Purchase of cottonseed was not a practical method of protecting the taxpayer against sales at unfavorable prices (R. 37–38).

The taxpayer entered into the transactions in futures solely as a protection against sales of crude oil which it was compelled to make at prices which it deemed unsatisfactory, and those transactions enabled it to maintain a position in respect to future market conditions of refined oil which it was powerless to maintain in respect to crude oil (R. 38).

The futures were bought and sold by the taxpayer only on the New York Produce Exchange, through brokers. The taxpayer had no customers of its own in respect thereto. The contracts were neither stock in trade nor property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business (R. 38).

The taxpayer on its income tax return for the taxable year claimed deductions for the losses sustained in its transactions in futures. The Commissioner held that the losses resulted from the sale of capital assets within the meaning of Section 117 (b) of the Revenue Act of 1934; limited the deduction to $2,000, as provided in Section 117 (d); and determined a deficiency accordingly (R. 10–13). The Board of Tax Appeals reversed his determination (R. 48), holding that the transaction should be excluded from Section 117 because it was a hedging transaction (R. 48). The Circuit Court of Appeals reversed, with one dissent (R. 118).

ARGUMENT

This case does not present a conflict of decisions. It was correctly decided below and does not call for further review.

1. Deductions on account of losses from sales of capital assets are limited by Section 117 (d) of the Revenue Act of 1934 to $2,000 over gains from such sales. The principal question herein is whether the contracts for future delivery were "capital assets." Section 117 (b) defines capital assets as follows:

> * * * "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the

> taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

The contracts were certainly property held by the taxpayer (*Covington* v. *Commissioner,* 42 B. T. A. 601, affirmed on this point, 120 F. (2d) 768 (C. C. A. 5), pending on petition for certiorari, Nos. 693–694, present Term), and were not one of the three types of property expressly excluded in the statutory definition of "capital assets." They were neither stock in trade, nor were they held by the taxpayer primarily for sale to customers; for, the taxpayer had no customers with respect to these refined cottonseed oil futures, nor did it ever take delivery of the oil involved. Moreover, the contracts were plainly not the type of property which would be included in inventory. See Article 22 (c)–1 of Regulations 86 (Appendix, *infra*); A. R. M. 100, 3 Cum. Bull. 66, 68.

2. Section 117 (b) makes no exception for hedging transactions, nor has any exception been made therefor by Treasury Regulations. However, it has been the practice to permit deductions in full upon losses from true hedging transactions. G. C. M. 17322, XV–2 Cum. Bull. 151. The theory is that hedging is a form of insurance of normal business profits against the risk of fluctuations in

423663—41——2

the market price of the product in which the taxpayer deals or in the market price of the materials which are used by him to make that product.[1] But this case does not present a true hedging transaction.

It is a condition precedent to every hedging operation that there must be an existing trade risk in the cash or spot market at the time that the hedging operation is entered into. Hoffman, Future Trading upon Organized Commodity Markets (1932) 382. Here there was no such existing trade risk at the time of the alleged hedging operations. Such risks as the taxpayer had, due to the fluctuations of prices in the cash market prices of crude cottonseed oil and cottonseed, it took, and, while they existed, the taxpayer did not insure or protect itself against them by hedging. It was not until after these risks had come to an end by sales of crude cottonseed oil in the cash or spot market, sometimes several weeks after, that the taxpayer went into the futures market for refined cottonseed oil. (R. 36.) In doing so, the taxpayer was not

[1] That hedging is a form of insurance of normal business profits against such risks is well recognized. *United States* v. *Coffee Exchange*, 263 U. S. 611, 619; *Board of Trade* v. *Christie Grain and Stock Co.*, 198 U. S. 236, 249; Baer and Woodruff, Commodity Exchanges (1929) 87–88; Hoffman, Future Trading Upon Organized Commodity Markets (1932) 4.

insuring itself against any then existing trade risk in the cash or spot market for crude cottonseed oil or cottonseed. The taxpayer was, therefore, not hedging,[2] and the reason for permitting the deduction in full of losses from a hedging transaction does not exist in this case.

---

[2] That what the taxpayer did was not to hedge and what would be a proper hedge for a crude cottonseed oil manufacturer in the refined cottonseed oil futures market is shown by the testimony, before the Committee on Agriculture and Forestry of the United States Senate, of William A. Storts, representing the New York Produce Exchange, which maintains the largest futures market in refined cottonseed oil in the United States and which the taxpayer used for the future transactions involved in the case at bar. He said (Senate Hearing before the Committee on Agriculture and Forestry on S. 1414, 70th Cong., 1st Sess., p. 9 (April 11, 1928)):

"Many of the crude mills do not use the market as a hedge. Some of them do. The proper operation of a crude mill, in my opinion, when the market is used for insurance purposes, is to sell the market when he buys his seed. That is his hedge. There is not more than 1 out of 25 that does that, if there are that many. From what I can understand, the crude mill will buy the seed, produce the crude, and then, when they sell the crude, they buy futures, so that they are always long on the market, in place of having a hedge. That is the way it appears to operate, from the information I get through talking to people about it, in the majority of cases."

See also, United States Department of Agriculture Circular No. 151, Hedging in Grain Futures (June 1931), pp. 30–32.

CONCLUSION

The decision of the court below is correct. There is no conflict with the decision of any other Circuit Court of Appeals or with any decision of this Court. No question of general importance is presented. The petition should be denied.

Respectfully submitted.

CHARLES FAHY,
Acting Solicitor General.
SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
J. LOUIS MONARCH,
EDWARD H. HAMMOND,
Special Assistants to the Attorney General.

OCTOBER 1941.

APPENDIX

Revenue Act of 1934, 48 Stat. 680:

SEC. 22. GROSS INCOME.

* * * * *

(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. (U. S. C., Title 26, Sec. 22.)

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise. (U. S. C., Title 26, Sec. 23.)

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * * (U. S. C., Title 26, Sec. 101.)

* * * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 22 (c)–1. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise in-

tended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.

ART. 23 (f)–1. *Losses by corporations.*— Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible except in so far as not prohibited or limited by sections 23 (g), 24 (a) (6), 112, 117, 118, and 251. The provisions of articles 23 (e)–1, 23 (e)–2, 23 (e)–3, 23 (e)–4, 23 (e)–5, and 23 (h)–1 are in general applcable to corporations as well as individuals. See section 232 as to deductions by foreign corporations.

ART. 117–1. *Meaning of capital assets.*— The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a "capital asset," the period for which held is immaterial.

ART. 117–2. *Limitations on capital gains and capital losses.*—

* * * * *

Section 117 (d) provides a limitation on deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. * * *

* * * * *

G. C. M. 17322, XV-2 Cum. Bull. 151-152, 155 (1936):

REVENUE ACT OF 1934

Treatment of hedging transactions for Federal income tax purposes.

The opinion of this office is requested whether losses from hedging futures transactions on commodity exchanges constitute "capital losses" subject to the limitations of secton 117 (d) of the Revenue Act of 1934, which provides in part that "* * * Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *"

The instant taxpayer is a textile manufacturer. As a means of protecting itself against fluctuations in the price of cotton, the taxpayer entered into a series of hedging transactions in cotton futures which resulted in a net loss in 1934. Typical situations in which protection is obtained by the use of hedgng transactions are submitted by the taxpayer and may be illustrated as follows:

(1) The taxpayer buys quantities of spot cotton, which will necessarily be on hand for some months before being manufactured into goods and sold. In order to be protected against losses which would be incurred if the cotton market declined during

those months, the taxpayer, at the same time the above purchases are made, enters into futures sale contracts for the delivery of equivalent amounts of cotton a few months hence. As the above quantities of spot cotton are subsequently disposed of by sales from time to time of manufactured cotton goods, the above futures sale contracts are concurrently disposed of by futures purchase contracts which serve as offsetting transactions closing out the futures sale contracts.

(2) The taxpayer makes contracts for future delivery of cotton goods, the manufacture of which will require more cotton than the amount on hand or the amount which can be immediately purchased advantageously. In order to secure protection against a rising cotton market during the months that intervene between the date of the order for cotton goods and the agreed delivery date, the taxpayer, at the same time the above orders are taken, enters into futures purchase contracts for cotton in amounts necessary to provide the desired protection. As the taxpayer from time to time buys spot cotton for the manufacture of the goods specified in the above orders, the futures purchase contracts are disposed of by futures sale contracts which serve as offsetting transactions closing out the futures purchase contracts.

Such hedges, which eliminate speculative risks due to fluctuations in the market price of cotton and thereby tends to assure ordinary operating profits, are common trade practices and are generally regarded as a form of insurance (the only kind available as protection against such risks) necessary to conservative business operation. Where

futures contracts are entered into only to insure against the above-mentioned risks inherent in the taxpayer's business, the hedging operations should be recognized as a legitimate form of business insurance. As such, the cost thereof (which includes losses sustained therein) is an ordinary and necessary expense deductible under section 23 (a) of the Revenue Act of 1934 and corresponding provisions of prior Revenue Acts. Similarly, the proceeds therefrom in the form of gains realized upon hedging transactions are reflected in net income, either indirectly by compensating for losses realized on the sale of spot cotton thereby making such losses nondeductible, or directly by their inclusion in income as compensating for fluctuations in the market price of cotton adversely affecting the selling price of cotton goods or the cost of raw materials necessary to the manufacture thereof.

* * * * *

It follows from the above that hedging transactions are essentially to be regarded as insurance rather than a dealing in capital assets within the comprehension of section 117 of the Revenue Act of 1934. Regardless of accounting or inventory methods in use, provisions pertaining to capital gains and losses govern gains or losses on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

U. S. GOVERNMENT PRINTING OFFICE: 1941